THE EFFECT OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE OF SOME SELECTED SERVICE FIRMS IN NIGERIA: THE AGENCY COST PERSPECTIVE

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Abstract
This work examines the effect of capital structure on the financial performance of some selected non- financial service firms in Nigeria from the agency cost perspective with a sample of four (4) out of the population of twenty three (23) firms listed on the Nigerian Stock Exchange (NSE) for the period of ten (10) years; 2000- 2019. Panel data which consist of time series and cross sectional data for the firms were generated and analyzed using fixed effect, random effect and Hausman specification test. The independent variable which served as a surrogate for financial performance was used in the study as return on assets (ROA), while the dependent variables which served as surrogates for capital structure are; long term debt to capital (LDC), debt to capital (DC), debt to common equity (DCE) and short term debt to total debt (SDTD). The result shows that there is a positive and significant relationship between capital structure and financial performance of service firms, and those firms experiencing agency conflicts and need to raise funds for operations and expansion should give priority to higher debt ratio, also high interest rate is a hindrance for borrowing in Nigeria. It is recommended that government needs to regulate the financial sector through monetary and fiscal policies in order to reduce the cost of borrowing and appropriate mix of capital structure should be adopted by management but priority should be given to borrowing.

Keywords: Capital structure, Financial Performance, Service firms, Agency Cost,

1.0 Introduction

Capital structure is the total amount of funds needed to start a business, in other words, it is the act of financing an organization. Both the firm's leadership and the fund providers care deeply about how an organization is financed. This is because the performance and survival of a company enterprise can be substantially harmed if the improper combination of financing is used. In finance, capital structure refers to how companies finance their assets using a combination of equity, debt, and hybrid securities (Saad, 2010). A company's capital structure is made up of long-term and short-term debt, common equity, and preferred equity (Akintoye, 2008). The core focus of capital structure is on how a company finances its overall operations and expansion by utilizing a variety of funding sources (Tsuji, 2011).

Every firm requires finances to carry out its operations on a global scale, as no success can be accomplished without them. The required finances may be used to conduct the business's activities, necessitating the use of a well-planned capital structure (Ishaya & Abduljeleel, 2014). A company's capital structure relates to how it funds its assets via equity, debt, or hybrid securities (Ishaku & Danjuma, 2011). Despite the fact that capital structure has been extensively studied, it remains one of the most disputed topics in financial theory throughout the last century (Ogebe, Ogebe & Alewi, 2013). The capital structure issue has been identified as a major factor in corporate success and failure. If enterprises in Nigeria are to continue and play an expanding and dominant role in creating value, they must be able to finance their operations and expansion over time. Creating jobs and income for households in the form of profits, dividends, and wages, expanding the direct productive sector of the economy, generating tax revenue for the government, and facilitating poverty reduction through fiscal transfers. One of the major challenges confronting any firm's management in Nigeria and around the world over time is determining how to reduce capital costs while increasing shareholder wealth (Mustapha & Osama, 2011). To attain these goals, financial managers must first comprehend the source of cash needed to fund the firm's growth, as well as the most efficient use of that capital. As a result, the concept of capital structure is critical to any company's operations. Several empirical studies have been conducted to study the impact of capital structure on firm performance, in acknowledgment of the growing importance of capital structure to companies. However, the majority of empirical studies (Leon, 2013; Rahul, 1997; Aliakbar, Seyed & Pejman, 2013; and Leland, 1994) were conducted in foreign-based industries. Only a few studies have focused specifically on Nigerian industries (such as Taiwo, 2012 & Babatunde, Akinwunmi, Khadijah & Yusuf, 2014). Foreign study findings are extremely important; nevertheless, differences in political and economic realities among nations may make it difficult for their conclusions to be applied in Nigeria. Furthermore, the lack of empirical evidence documented in Nigeria has created a literature gap. This shows that there are inadequate empirical basis for examining the impact of capital structure on financial performance in Nigeria. Thus, the focus of this research is to empirically investigate the impact of capital structure on financial performance with reference to some selected service companies in Nigeria. This will enrich the literature and provide results that would serve as basis for policy formulation.

2.0 Literature Review

This section of the paper consists of both the theoretical and empirical literature reviews.

2.1 Theoretical Review- Agency Cost Theory

Agency cost was described by Jensen and Meckling (1976) as the study of disputes and relationships between agents (Managers) and principals (shareholders). These conflicts are caused by the conflicting interests of principals and agents, as well as the separation of management and ownership in a company. Managers, for example, may be more interested in adopting negative NPV projects or making unneeded acquisitions by paying too much to improve the firm's size and reputation than in maximizing the wealth of shareholders, because huge businesses pay their executives well. Managers aim to run the company in their own best interests rather than enhancing the wealth and worth of the company for the shareholders.

Finally, the agency cost theory claims that an optimal capital structure can be achieved by lowering the costs associated with conflicts between managers and owners. The leverage

level, according to Jensen and Meckling (1976), can be used to assess managers' efforts to pursue the overall firm's goals rather than their own. As a result, costs are lowered, resulting in increased efficiency, which will ultimately improve firm performance (Buferna et al., 2005).

2.2 Empirical Review.

To investigate the relationship between corporate governance and capital structure, Bodaghi and Ahmadpour (2010) gathered data from 50 Iranian enterprises listed on the Tehran stock exchange. They came to the conclusion that board size and debt to equity ratio have a negative association. The authors also discovered that CEO duality had little effect on company funding decisions. From 1998 to 2006, Saad (2010) studied 126 Malaysian publicly traded firms from four industries: consumer products, industrial products, trading/services, and plantation. Saad discovers a negative association between CEO duality and capital structure, as well as a positive relationship between board size and capital structure, using multiple regression analysis. In the United States, Coles et al. (2005) discovered a positive link between board size and debt ratio. Small business growth and family favorably influence capital structure and small business enterprises, according to Gil, Mand, Sharma, and Mathur (2012), who studied small company owners in India.

From the standpoint of agency cost theory, Onaolapo and Kajola (2010) conducted a study on the impact of capital structure and performance of Nigerian enterprises for a period of seven years (2001-2007), focusing only on non-financial firms. According to the findings, capital structure, as measured by debt ratio (DR), has a considerable negative influence on financial indicators such as return on assets (ROA) and return on equity (ROE) (ROE). This finding lends credence to the agency cost argument.

Oke and Afolabi (2011) also looked into the impact of capital structure on industrial performance in Nigeria, using debt financing, equity financing, and debt/equity financing as proxies for capital structure and profit efficiency as a surrogate for performance. A favorable association existed between equity and debt equity finances, but a negative relationship existed between debt financing and performance.

Furthermore, for a four-year period (2005-2008), Ong and Teh (2011) evaluated the capital structure and firm performance of construction enterprises in Malaysia. Long term debt to capital, debt to capital, debt to asset, debt to equity market value, debt to common equity, long term debt to common equity were used as proxies for capital structure (independent variable), while return on capital, return on equity, earnings per share, operating margin, and net margin were used as proxies for corporate performance (dependent variable). The findings indicate that capital structure and business success are linked.

The link between capital structure and financial performance is exploited by Javed and Akhtar (2012). They came to the conclusion that financial leverage, financial performance, as well as company development and size, all have a favorable association. The relationship between capital structure and performance of listed enterprises on the Tehran Stock Exchange was investigated by Saeedi and Mahmoodi (2011). According to the study, market performance metrics are positively associated to capital structure, and while ROA is positively related to capital structure, ROE and capital structure have no meaningful association.

Abdul (2012) did a similar study in Pakistan to examine the link between capital structure

decisions and firm performance. Financial leverage has a significant negative link with company performance as evaluated by ROA, GM, according to the study. Financial leverage had a negative association with company performance as assessed by ROE, but it was not statistically significant. Similar studies by Berger and Bonaccarsi di Patti (2006), Gleason et al. (2002), and similarly and Li (2002) found a negative association between capital structure and firm performance.

The impact of capital structure on the performance of enterprises listed on the Tehran stock exchange was researched by Aliakbar, Seyed, and Pegman (2013). The study used capital structures as an independent variable, which was proxied by the ratios of short-term debts to total assets, long-term debt to total assets, and total debts to total assets, and performance as a dependent variable, which was represented by the Tobin's Q ratio. A total of 81 companies from the Tehran Stock Exchange were picked (2005-2011). Regression analysis was used to examine the data. The findings revealed that capital structure and company performance had a favorable and significant association. The analysis suggested that the capital structure be optimized. Both geographical coverage and time coverage of the study call for a fresh investigation.

In Nigeria, Taiwo (2013) looked at the impact of capital structure on firm performance. All of the variables were non-stationary at level, according to the Pesaran and Shine unit test results. However, Panel Least Square results revealed that asset turnover, size, company age, and tangibility of assets were all positively connected to business performance. In the model, the findings revealed a negative and substantial link between asset tangibility and performance. Asset tangibility should be a driving force in capital structure, according to the study, because organizations with more tangible assets are more likely to be financially restricted. This study does not incorporate all the essential variables for capital structure. Hence, relationship between capital structure and firm performance cannot be established using this study.

Mustafa and Osama (2013) investigated the capital structure and performance of public Jordanian companies listed on the Amman Stock Exchange. The data on 76 firms for the time was analyzed using the Ordinary Least Square approach (2001-2006). The study's findings revealed that capital structure had a statistically significant negative relationship with firm performance. The study also found that financial leverage has no influence on growth and that there is no difference in performance between high and low growth enterprises with financial leverage. The report recommended taking a cautious approach to a company's debt composition.

Using correlation coefficient and regression approaches, Babatunde, Akinwunmi, Khadijah, and Yusuf (2014) evaluated the impact of capital structure on profitability of 10 chosen quoted enterprises in Nigeria from 2000 to 2011. The findings revealed that across all firms, there was no significant association between capital structure (debt to equity ratio, debt to asset ratio, and return on asset). The study recommended that all firms that want to maximize shareholders wealth to increase their leverage while firms that wish to ensure stakeholders' performance should increase their assets and that a mix of the firms' leverage and assets at an appropriate ratio will be considered a good capital structure for the firms.

With empirical evidence from the Colombo Stock Exchange, Nadeesha and Pieris (2014) evaluated the impact of capital structure options on firm performance in Sri Lanka. During the period 2011-2012, the study looked at all publicly traded non-financial companies. The estimation of functions connecting the return on capital employed

(ROCE) with measure of capital structure was done using stepwise multiple regression analysis. The debt to total assets ratio and return on capital employed had a substantial positive relationship, according to the findings. For companies looking to improve their long-term profitability, a high debt-to-capital ratio was advocated. The reliability of this study rises between concerns as the study considers only foreign firms whose capital structure characteristics differ significantly from their Nigerian counterparts.

With a sample of seventy out of two hundred and forty-five enterprises registered on the Nigerian Stock Exchange (NSE) from 2000 to 2009, Ishaya and Abduljeleel (2014) investigated capital structure and profitability of Nigerian listed firms from an Agency Cost Theory perspective. Multiple regression analysis was used to produce and evaluate panel data. The debt-to-equity ratio was found to be inversely associated to profitability, while the equity-to-debt ratio was found to be directly related to profitability. The backward nature of the time period necessitates new research.

Bindu C. (2021) investigates the link between capital structure and financial performance of Indian two- and three-wheeler manufacturers. The study looked at all two- and three-wheeler manufacturing companies listed on the BSE for a period of ten years, from 2007-08 to 2016-17. According to the Hausman test, an econometric model with fixed effects is utilized for the analysis. The financial performance was measured using the accounting metric Return on Equity. The findings revealed that capital structure had a detrimental impact on these organizations' financial performance.

Vu Thi, A. H. (2021). Investigates the impact of capital structure, working capital, and governance quality on the financial performance of small- and medium-sized enterprises in Taiwan using a sample of more than 2000 firms from the Taiwan Economic Journal (TEJ) during the 24-year period of 1995–2018. Panel data are used to create statistics for the regression model. The result shows that a firm’s capital structure, represented by the debt ratio, has a significantly negative impact on the firm’s financial measures (return on assets (ROA) and return on equity (ROE)), where the working capital, represented by the cash conversion cycle (CCC), has a negative impact and governance quality, represented by the board size, cash dividend distribution, and the percentage of directors, has different impact.

3.0 Sources of Data and Methodology

The study used panel data which consists of time series and cross - sectional data. Multiple regression analysis was carried out to ascertain the relationship that exists between capital structure and financial performance of service (non-financial) companies listed on the Nigerian Stock Exchange. The data for all the variables in the study were extracted from published annual reports and financial statements of the service companies listed on the Nigerian Stock exchange for the period 2010 - 2019. The dependent variable for this study is return on asset (ROA) as a measure of financial performance. The independent variables are; long term debt to total capital (LDC), debt to total capital (DC), debt to common equity (DCE) and short term debt to total debt (SDTD) as measures of capital structure. The population of this study consists of 23 non-financial service companies listed on Nigerian stock exchange which have been sampled using judgmental sampling method. Four (4) companies out of the 23 listed non- financial service firms were selected to represent the entire population as they have the complete data required for the period under review.

This research adopted the model of Osuji,C.C; and Odita, A. 2012 with little modification which is written as

Fp=f(LDC, DC,DE, SDTD)…….....3.1

Where FP (Financial Performance) would be measured by ROA. Thus, the model to be estimated would be written as:

$ROAit = B_0 + B_1LDC_{it} + B_2DC_{it} + B_3DE_{it}\ B_4SDTD_{it} + E_{it}$…….....3.2

Where: ROA_{it} = return on assets for firm 1 at time t (in years) used as a proxy for performance,

LDC_{it} = Long - term debt to total capital

DC_{it} = Debt to total capital

DCE_{it} = Debt to total equity

$SDTD_{it}$ = Short term debt to total debt.

E_{it} = Stochastic or disturbance term

B_0 = Constant or intercept

B_1-B_5 = Coefficient of the estimated Parameters

Apriore expectations $B_0>0$, $B_1>0$,$B_2>0$,$B_3>0$,$B_4>0$,$B_5>0$.

Table 3.1; Variable Measurement

VARAIBLE	MEASUREMENT
R.O.A (Return on asset)	Is measured as the ratio of profit after tax to total asset. This is in line with the work of Osuji,C.C; and Odita, A. 2012
L.D.C (Long term debt to total capital)	Is measured as the ratio of long term debt to total capital. Adapted from the work of Akinyomi,O.J.2013
D.C (Debt to capital)	Is measured as the ratio of debt to total capital. Adapted from the work of akinyomi,O.J.2013
D.C.E (Debt to common Equity)	Is measured as the ratio of total debt to total equity. Adapted from the work of Akinyomi,O.J.2013
SDTD (Short term debt to total debt)	Is measured as the ratio of short term debt to total debt. Adapted from the work of Akinyomi,O.J.2013

4.0 Results and Discussion

The Fixed effect and Random effect regression posits results with all parameter estimates of Long term debt to capital, Debt to Capital, Debt to Common Equity and Short term Debt to Total Debt and its relationship with Return on Asset The results is presented on the table 1 below.

Table 4.1 Regression Results for the whole Sample (Fixed and Random Effect)

Dependent variable: Return on Assets (ROA)		
Independent variables	Coefficient estimates and t-ratios	
	Random Effect Regression	Fixed Effect Regression
LDC	12.65171 (1.19)***	8.70068 (11.30)***
DC	2.77726 (2.75)***	1.28802 (0.37)***
DCE	2.88078 (1.02)*	1.05686 (0.14)*
SDTD	1.58534 (0.18)***	0.6460572 (0.99)***
Constant	1164.938 (1.55)***	1158.091 (1.78)***
R^2	0.8232	0.8702
F	539.25***	180***
Significant at 1% (***), 5% (**) & 10% (*)		

Source: Computed using Stata 10.0

Table 4.1 shows the type of relationship that exists between the dependent and

independent variables. The fixed effect regression posit results with all parameter estimate of Long term debt to capital, Debt to capital, Debt to equity and Short term debt to total debt. Having either positive or negative relationship with Return on Asset (ROA). From the table, variables such as long term debt to capital, and short term debt to total debt, have positive and significant relationship with the dependent variable ROA even at 1% level. From the results, the coefficient estimates for long term debt to capital, debt to capital and short term debt to total debt stood at 12.65171, 2.77726 and 1.58534 respectively. Debt to equity is positive and significant but at 1% level. The constant term coefficient estimate is 1164.934and also significant at 1% level. The R^2 value is 0.8232 which means 82% of the variation in the dependent variable ROA can be explained jointly by the four variables against the value of the value of the F-statistics is 539.25 and also significant at 1% level. This indicates that the model is adequate. On a general note, the independent variables are positive and significant either at 1% or at 10% and the model proof to be adequate, from the result of the F-statistic and the R^2 is also high.

From the same table 4.1, the result of the Random effect is presented, and from the table, the coefficient estimates for all the variables are positive and significant even at 1% level. Again only debt to equity is significant at 10% level. The coefficient estimates for the independent variables, long term debt to capital, debt to capital, debt to equity and short term debt to equity stood at 8.0068, 1.28802, 1.05686 and 0.6460572.The R^2 value is 0.8702 which means 87% of the variation in the dependent variable ROA can be explained jointly by the independent variables. The F-statistic stood at 180 and significant at 1% level, meaning that the model is adequate and can be used for projection.

On a general note, both FE and RE models are adequate and both the variables in the FE model and RE model are positive and significant. However, for us to decide on the model to base our analysis, we need to carryout Hausman specification Test of 1978 in other to choose the model that our analysis will be based on.

Table 4.2 below presents the results of Hausman (1978) specification test in order to choose which model is appropriate between Fixed effect and Random effect.

Table 4.2: Result of the Hausman Specification Test

Variables	Coefficients		
	Fixed Effect (b)	Random Effect (B)	Difference (b-B)
Long Term Debt To Capita	12.65171	8.70068	3.951025
Debt To Capital	2.7726	1.288302	1.48894
Debt To Equity	2.880978	1.05606	.48894
Short Term Debt To Total Debt	1.58535	0.6460572	.9392765
Chi^2 (4) = 26.24			
Prob>Chi^2 = 0.0010			

Source: Computed using Stata 10.0

Table 4.2 above presents the results of the Hausman test for fixed effect and random effect models. Following the diagnostic test, the Hausman specification selected the fixed effect model as more appropriate than the Random effect model. This is because the p-value indicates the significance of the test at 1% level leading to the rejection of the null hypothesis and the acceptance of the alternative hypothesis that fixed effect model is more appropriate than Random effect model.

The study revealed four important findings. First, the result of the findings shows that there is a positive and significant relationship between long term debt (LDC) and financial performance of non – financial service firms in Nigeria. What this means is that any increase in long term debt will result to increase in the financial performance of service firms. Secondly, it was found that there is a positive and significant relationship between debt to capital and financial performance of non-financial service firms. It means firms should go for higher leverage at a given percentage of interest rate in order to mitigate the conflict of interest that exists between Managers (agents) and investors (owners).

Thirdly, it was found that there is a positive and weak significant relationship between debt to common equity and financial performance of service firms. What this means is that firms that need funds for operations and expansion could do so either through equity or debt financing, but it is advisable for firms to give priority to debt financing than equity financing. This is because equity financing has a weak significant level of relationship even at 10%. Lastly, it was found that there is a positive and significant relationship between short term debt to total debt and financial performance of service firms. What this means is that increase in short term debt will result to an increase in the financial performance of service firms. The results provided strong empirical support for the three hypotheses and a week support for one.

5.0 Conclusion and Recommendations

Based on the findings of this study, the following conclusions were drawn; It was found that there is a positive and significant relationship between long term debt to capital, debt to capital and short term debt to total debt and financial performance of non-financial service firms in Nigeria even at 1% level. This means that an increase in any of the above variables will result to an increase in the financial performance of non-financial service firms. Therefore, government should regulate the financial sector through monetary and fiscal policies in order to reduce the cost of borrowing i.e. interest rate in Nigeria, given that the performance of non-financial service firms will be enhanced if given access to borrowing at a low cost (low interest rate). This is very important not only in terms of enhancing the performance of the firms, but also on employment and economic growth. Thus, the outcome provide evidence in support of agency cost theory which postulates that financial leverage mitigate against agency problems; that higher leverage result in the reduction of agency cost, improves efficiency and making the firm more profitable. Therefore, firms experiencing agency conflicts and needs to raise funds for operations and expansion should make debt financing a priority.

It was also discovered that there is a positive and significant relationship between debt to common equity and financial performance of non-financial service firms even at 10% level. In other words, a weak form of significance between debt to common equity and financial performance of service firms. This means that appropriate mix of debt and equity should be considered when financing non-financial service firms, but debt must be given more priority over equity. Finally, management needs to make prudent financial decisions and also try to improve on the firms leverage ratio as it will go a long way in determining their survival since debt has become so important in solving agency conflicts.

In line with the findings, the following recommendations are hereby made:

I. The study recommend that government should regulate the financial sector through monetary and fiscal policies in order to reduce the cost of borrowing in Nigeria given that

firms rely mostly on borrowing to finance their operations.

II. Appropriate mix of capital structure should be adopted by management of non-financial service firms in order to increase their performance. It means that managers of non-financial service firms should concentrate more on long term debt in order to finance their assets. This is because this study provides evidence in support of agency cost theory that the use of debt enhances performance, reduces agency cost and improves profitability.

III. Firms experiencing conflicts and needs to raise funds for operations and expansions, higher debt ratio should be given priority. Appropriate mix of equity and debt must be ensured with debt given priority over equity. This is evidence from the result of our findings, when debt financing is positively and significantly related to firm performance, equity financing is positively but not significantly related to financial performance of service firms.

IV. Management needs to make prudent financial decisions and also try to improve on the firms leverage ratio as this will go a long way in determining their survival since debt has become so important in solving agency conflict. It should come to the knowledge of policy makers and economic agents' i.e. individual investors and firms that the financial performance of non- financial service firms in Nigeria depends largely on proper management and composition of their capital structure.

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